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## **The Economic Impact of Registered Pledge System in Latvia**

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# **Introduction**

## **The Goals and Justification for the Project**

The goal of the project was to perform the analysis of the registered pledge system in Latvia. This was done in multiple stages – first, by providing the description of the current registered pledge system and then by discovering the drawbacks of the status quo for the participants of the system (in particular for the banks). Ultimately, this research has formulated recommendations for improving the status quo and creating a safer and more efficient registered pledge system.

Registered pledge system is an integral part of creditor and debtor relationship, which are at the core of financial system. A research of this question under the auspices of the organization with a potential to improve the existing situation will undeniably promote greater stability, efficiency and overall development of the financial sector, which are express goals of the PFS (Partnership for Financial Stability) program.

## **Background Information**

In the first years after restoring independence in Latvia many businesses were experiencing difficulties with obtaining bank loans to increase money reserves or implement development plans. Private entities had even less ability to obtain loans for the purposes such as purchasing durable goods, building or reconstruction of real estate. Such a situation was caused by the lack of economic stability and adequate collaterals for the loans, which was increasing loan risk, as well as by the high levels of inflation and loan interest rates. The volume of resources, which banks could direct for long-term purposes, was also limited due to the short-term deposit base. The situation was further complicated by the banking crisis of 1995 as well as by the consequences of the financial crisis in Russia in 1998. In spite of all of the above-mentioned difficulties, the supply of loans has notably stabilized after the crises in the banking system, with the greatest changes during the last four years. An increase in the amount of provided loans was caused by the following factors:

- Latvian economy had successfully overcome the consequences of Russian economic crisis;
- The number of bank clients had increased. Overall loan quality had also increased with the creation of pledge registry and the increased availability of credit history for the companies;
- Loan interest rates had decreased (from the short-term rate of 119.6% and the long-term of 48.4% in the January of 1993 to 7.4% short-term and 5.4% long-term in the December of 2002.). Inflation had also decreased considerably;
- The resource base of financial system had increased as it was becoming more mature;
- Macroeconomic and business environment was becoming increasingly stable.

Because of these positive tendencies, the amount of loans provided by Latvian banking sector has surpassed 1.8 billion lats in the end of 2002 (for comparison – in the end of 1993 it was only 0.3 billion lats). The ratio of loans to GDP has increased from the 18% in 1993 to 35% in the 2002.

Thus, the tendencies for development of registered pledge system have been largely positive. However, the situation is far from being stable or perfect. The process of reform, in particular the process of creating pledge registry and legislation, is not yet fully completed. This is an overall problem, which includes several more specific ones, for example, the creation of debtor's registry, control over the movement of pledge property, pledge evaluation, registration and regulation of pledges. Together with all of the above-mentioned and perhaps most importantly, there is a great necessity for evaluating current situation in the industry and its impact on the economic climate in the country. There should be a discussion, involving all of the participants of the system, about further perspectives of improvement. The speed of development of Latvian economy has been noticeably greater than corresponding development of legal, regulatory and cultural infrastructure. Therefore not all of the components of economic development have been clearly researched and evaluated. However, such an evaluation is necessary, in order to secure the successes of spontaneous development and achievement of even better results.

## **The Objectives of the Project**

The main objectives of the project are as follows:

- To research and analyze the main descriptive variables of registered pledge system as well as the role of the state in it. Particular attention should be paid to the factors conducive to the development of the system, as well as factors preventing it. This objective addresses the incomplete reforms, which are described above in the background information. In addition, it will help to evaluate achieved success, future perspectives and create a plan of further measures.
- To identify organizational, structural and legal problems of registered pledge system (partially based on its analytical and statistical description) and offer solutions. This objective addresses the practical implications of unfinished and slow reforms – control over pledges, their evaluation, etc.
- To identify risks and considerations of banks, which are related to the registered pledge. This objective will help to adopt recommendations for more successful operations of banks, which will help to create a more efficient and developed financial system.

The authors of the research would like to express their gratitude to banks that have chosen to provide the information for the questionnaire developed for the project as well as personally to Lilija Babre, Evija Sloka and Žanete Glaudina.

# **1. Description of Latvian Registered Pledge System**

## **1.1. The Stages of Development of the Notion of Registered Pledge and Corresponding Legislation**

### **1.1.1. The Origins of Pledge Rights During the First Republic (1937 - 1939)**

Although ideas about the notion of pledge have appeared in Latvian legislative history already in the XIX century, the concepts that form the foundation of modern pledge legislation were first included in the Civil Law of 1937. That law had contained provisions for three types of pledge:

- *Direct pledge.* This type of pledge meant, that the creditor was obtaining total control over the pledged property.
- *Direct pledge with usage rights.* This type of pledge was the same as above with the exception of the fact that creditor had the rights to use and obtain revenue from the property that was pledged.
- *Mortgage* was related to the real estate and ships, which were pledged without transferring them under control of the creditor.

**The drawback of the Civil Law of 1937 was the fact, that there were no provisions, which would consider pledging moveable property without transferring it under control of the creditor, which is the foundation of modern concept of registered pledge [6].**

### **1.1.2. The Development of Registered Pledge Concept After Regaining Independence (1991 – 1996).**

Quite naturally the legislation of the First Republic (1918 - 1940) was ignored during the Soviet times, and its operation on the territory of the Republic of Latvia was restored only after regaining independence from the USSR in 1991.

During the first years since the establishment of independence, with free enterprise and its infrastructure reappearing in Latvia, the rigidity of the Civil Law and its inability to respond to modern day requirements became clear relatively soon. There were a number of problems in the existence that needed solutions:

- The main problem was related to the fact, that a businessman, who would have to use a loan for developing one's business, was not interested to take one, if

that required pledging the capital under the rules of direct pledge that is transferring it under control of the creditor, because no business operation would be possible in that case. In addition, not many businesses would own real estate or a ship that could be pledged under the mortgage rules, which was at the time the only possibility for the debtor to keep using the pledge [8]. In order to escape the situation, artificial legal constructions were used, under which the subject of the pledge was transferred under the control of the control and simultaneously the rights to use it were granted to the debtor.

- The situation was further complicated by the fact that, although Latvian legislation in 1992 had contained provisions for creating real estate and ship registries, *there was no registry for moveable property*. This meant, that it was difficult for the creditors to safeguard themselves against fraudulent operations, for example, pledging the same property multiple times for different creditors. Many Latvian commercial banks have actually suffered from this type of fraud during the period of 1991 - 1995. Private businesses and persons were not registering pledges or pledged property, because the legislation did not provide and did not require public access to that kind of information, its accuracy, consistency and uniformity. Naturally banks suffered, encountering problems with recovering their loans. Many of the loans provided during that period had to be written off, because:

- *Firstly*, the development of Latvian banking industry during the first years of independence was much faster than the development of other industries in Latvian economy. The declining economy, slow speed of reforms and flawed legislation combined preserved a high amount of risk for bank operations;

- *Secondly*, although banks quickly increased their asset portfolios those assets were placed relatively airily, mainly by handing out loans without checking the ability of the clients to repay those. Those loans were frequently not secured with any pledges, or those pledges were not properly registered due to the lack of legal clarity of the procedure. Clients, that were trying to obtain loans had no developed credit history, which meant even

more risks and later worsened the structure of loan portfolio. The real estate and stock market were not yet fully operational in the country.

All of these problems culminated in the crisis of banking industry in 1995, which took a heavy toll on the economy as a whole.

- ***The legislation did not grant the rights to determine the priorities of different creditors for the same debtor to any registry.*** Thus one of the most fundamental principles of pledging property – *public availability of information* was violated, because no third parties (other creditors) could find out about the existence of the pledge. As a result difficult situations have occurred, when the same property was pledge multiple times to different creditors and afterwards fraudulently sold to somebody else, with creditors and buyers unaware.

Obviously, providing loans to economic agents under these circumstances was very risky, which didn't encourage decrease in interest rates or development of the economy as a whole. The drawbacks of this system had also led to other kinds of problems, for example, repossession of property by different agents, without the creditor being informed as well as problems with determining and preserving claim rights over property.

The work to develop suggestions for solutions of the above-mentioned problems had begun as early as 1996.

One of the proposed solutions was the suggestion to enlarge the definition of properties, which could be pledged without transferring them under control of the creditor, but rather registering the pledge in the corresponding registry, similar to the mortgage mechanism [4].

### **1.1.3. Creating Registered Pledge Legislation (1996 – today).**

Due to the lack of experience, it was difficult to create an all-encompassing law on registered pledges at once. Therefore, it was decided to prepare different changes in the already existing laws, in order to at least start the procedure of registering pledges. Later it was planned, that after summarizing the newly established practice, a law clearly describing registered pledge system would be drafted.

Thus, in 1997 changes in the following laws were prepared:

- The Law on Enterprise;
- The Law on Enterprise Registry of the Republic of Latvia;



- The Law on Aviation;
- Civil Law;
- Criminal Law;

Suggestions were also developed for the Law on Road Traffic, that was, at the time, under consideration in Latvian Parliament. It was believed that the above-mentioned changes were a minimal legislative package that was required to begin the procedure of registering pledged.

On the October 16<sup>th</sup> 1997 changes were made the Article 1279 of the Civil Law making it approximately as follows: *„A pledge of the moveable property can be established without transferring it to creditor according to the rules of registered pledges, which are defined in other laws.”*

During the preparation of these legislative changes, it was necessary to determine the institution, which would be registering the pledges according to the new procedure. Two obvious choices were considered:

- registration of all pledges by a single institution,
- registration of pledges by different institution, depending on the type of property pledged.

Since division of registration duties between different institutions was cheaper (it did not require creation of the new institution, but only assigned additional functions to the already existing ones), the government chose the second option, which was described in the Law on Enterprise. According to that pledges were to be registered by:

- The Enterprise Registry;
- The Road Traffic Safety Directorate;
- State Technical Control Inspection;
- Registry of Civil Aviation.

As the creation of legal underpinnings of the registered pledge mechanisms continued, the following rules were adopted:

- “Rules of Registering a Pledge” of February 24<sup>th</sup> 1998,
- “Rules on State Fees for Registering, Changing and Erasing the Pledge” of February 28<sup>th</sup> 1998,

- Changes to the “Rules on State Fees for Obtaining Information from Enterprise Registry of April 18<sup>th</sup> 1995” on February 18<sup>th</sup>, 1998. [4].

After considering and adopting all the necessary legislative changes, *the registration of pledges had begun in the March of 1998.*

Parallel to changing existing laws, *the work on creating a separate Law on Registered Pledges continued.* Here, Latvia was greatly helped by the specialists of European Bank of Reconstruction and Development (EBRD) and the United States Agency for International Development. A template law “On Operations with Collaterals” developed by the EBRD was helpful in drafting the Latvian law. Taking into account, the fact that fundamental principles of pledges were already defined in the Civil Law, the above-mentioned template could not be fully utilized. Only the principles that were possible to implement within the existing legislative framework were borrowed.

Initially, it was predicted, that a new normative document will become a separate part of the Law on Commerce, later, however, due to the fact that the development of Law on Commerce was delayed due to different reasons, *in 1998 a separate draw of the Law on Registered Pledges was prepared.*

On the one hand, the law was really required, because the practice had already shown that existing legislative changes were not sufficient for the successful development of the registered pledge. On the other hand, such an accelerated temp of development did not allow developing the law in the sufficient amount of detail, since there was not enough time from the beginning of registering pledges, to develop a uniform registration procedure.

*The Law on Registered Pledge* was adopted by the Parliament on October 21<sup>st</sup>, 1998 and enacted On March 1<sup>st</sup>, 1999. There were changes to the law, adopted on December 20<sup>th</sup>, 1999 and enacted on January 24<sup>th</sup>, 2000.

Since March 1<sup>st</sup>, 1999 the registration of pledges is determined by the Law on Registered Pledges. Still, this law will definitely require further changes, because as it's shown in the **Part 3** of this research, there are legislative problems remaining that need to be solved.

It's necessary to mention, that *during the preparation of the Law on Registered Pledges the viewpoint on the registering institution had changed and a single*

*institution approach was chosen.* Therefore changes to the Law on the Enterprise Registry of the Republic of Latvia were adopted. These changes stated that pledges, their renewals and nullifications are to be registered in the Enterprise Registry according to the procedures defined in appropriate laws and regulations.

*In March 1998, a special division of Enterprise Registry – Pledge Registry has begun registering pledges.* Therefore, we can state, that with the enactment of the Law on Registered Pledges and beginning of operation of the Pledge Registry, a totality of legislation and institutions has been created, that can be termed *registered pledge system*.

## **1.2. The Essence of Registered Pledge, the Mechanisms of Registering and Claiming a Pledge**

### **1.2.1. The Essence of Registered Pledge, the Mechanism of Registration**

It is first appropriate to point out some legal definitions. *Registered pledge* is a right to claim the pledge, which is registered in the Pledge Registry as required by the Law on Registered Pledges. [2, Article 2.1]

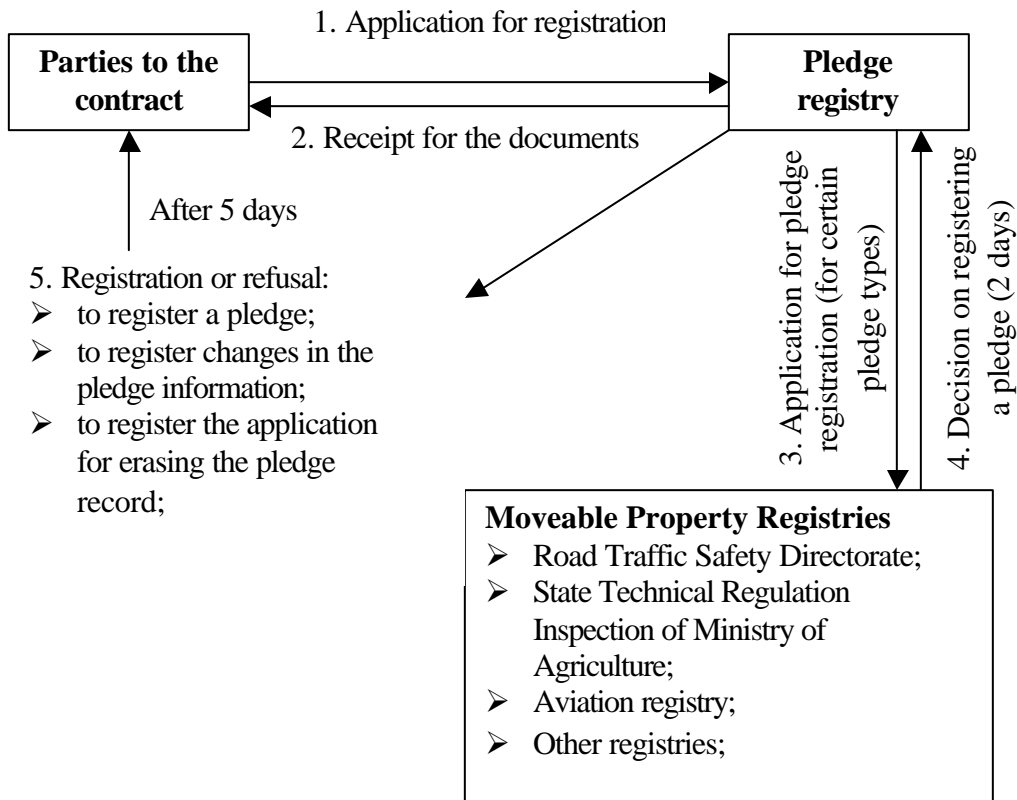
*Moveable property subject to registration* includes ground transportation vehicles, aviation devices (planes) and animal herds that are subject to registration [2, Article 1.3.]

Any registered pledge contract obviously requires two participants – the creditor (pledge taker) and the debtor (pledge provider). If the two parties to the contract have found each other and agreed on the terms of the loan and other details related to the contract – interest rates, terms of repayment, etc. then, upon the mutual agreement of the parties the debtor can choose any property allowed in the legislation to pledge.

The subject of the pledge is always the property of debtor, which it is not prohibited by law to repossess or claim, thus property that is not exempted from the civil regulations. Apart from the existing property, things that are to be created in the future can be pledged as well, for example, a farmer might pledge one's future harvest, in order to obtain a loan for seeds or fuel.

After agreeing on all the details, the parties to the contract have to go through *the application for registering a pledge*, which is a procedure described in the law. Schematically it can be represented as shown on **Scheme 1**.

### Scheme 1 Pledge Registration in the Pledge Registry



As seen from the **Scheme 1**, registration of a pledge occurs in the following way:

1. One of the parties to the contract submits the registration application (or the application to change the contract) to the pledge registry. It is possible to do it personally, by coming to the Pledge Registry main office, or regional offices of Enterprise Registry. It is also possible to mail the necessary documents. In the 2003 the possibility for certain parts of the application process to be completed electronically has appeared. The state fee for pledge registration (25 lats for establishing the primary registration or renewing it, 10 lats for changes in the contract, and 5 lats for erasing the pledge record [7]) is usually paid by the borrower.
2. After submitting the application for registering a pledge, the borrower obtains a receipt from the Pledge Registry. This document includes the application references number, date and time of receiving, as well as the day when the decision can be obtained. The details on the stages the process of reviewing is at

are possible to obtain on the Internet, where the application can be located by the reference number.

3. If property that is being pledged, is subject to registration, that is it consists of ground transportation vehicles, aviation vehicles or herds, then Pledge Registry electronically submits the application for registering a pledge to the corresponding registry (Road Traffic Safety Directorate, State Technical Regulation Inspection of Ministry of Agriculture, Aviation registry, etc.).
4. Those registries notify the Pledge Registry about registering or refusing to register a pledge in 2 days; even if a plane or a herd is being pledged, the corresponding registries are required to speedily process the request of the Pledge Registry.

***It is not possible to register the following types of property as a pledge:***

- ships;
  - publicly traded stock;
  - a claim derived from a check or a note payable;
5. Pledge registry reviews the applications for registration in the order they were submitted (it is impossible to accelerate this procedure) and:
    - a. either ***registers a pledge***, by issuing the a corresponding document – a pledge registration act,
    - b. or ***refuses to register a pledge***, by issuing a decision. If multiple things are pledged and there is a refusal to register a pledge for a transport vehicle, plan or animal herd, it's excluded from the total pledge (with a corresponding decision issued), but the rest of the property is still pledged.

Pledge registration lasts five days, excluding the day of submitting the documents. The applicant is to visit the Pledge Registry for a decision on the date specified in the receipt of the documents provided before. [7].

### **1.2.2. The Mechanism of Claiming a Pledge**

The objective of the Law on Registered Pledges in defining the mechanism of claiming a pledge, is to equalize the wish of the creditor to quickly recover the loan in case of difficulties, and the lawful rights of the debtor.

In case the terms of loan repayment are violated, the creditor can claim the pledge and sell it, in order to recover the principal amount of the loan.

The creditor obtains the rights to claim a pledge, when:

1. it's time to repay the loan (or make a periodic payment associated with the loan and interest) that is secured with the pledge;
2. the debtor did not fulfill one's payment commitments;
3. the creditor has reminded the debtor about failing to fulfill the payment obligation and about the intent to sell the subject of the pledge, unless the contract specified the rights for the creditor to sell the pledge without warning.

The Law on Registered Pledges and the Law on Enterprises and Enterprise Insolvency allow the creditor to sell the property pledged in order to recover the amount of the debt. The property has to be sold, it cannot be held instead of the debt, unless the debtor had agreed to that beforehand.

The creditor is allowed to ask the officer of the court to claim the pledge property in accordance to the Law instead of doing it oneself. The creditor in that case should turn to court with the request to use the right to claim the pledge. To that one should attach the act of registration provided by the Pledge Registry and additional documents (Article 403. of the Code of Civil Regulations) [1].

The courts checks whether the pledged has been registered in a due process and whether there has been a failure on the part of debtor to meet one's payment commitments (Articles 404. and 405. of the Code of Civil Regulations)[1]. Only after receiving the decision of the court, the creditor can ask the court officer to claim the property. This procedure has to be performed in 10 days, however in practice it can take a longer period of time.

#### ➤ ***Selling Property, in case of Multiple Creditors***

If there are multiple creditor, the creditor responsible for the sale, has to appoint the depositor of income, who will preserve the proceeds of the sale and deposit it in a separate account. A bank, a sworn auditor, a notary public or a lawyer can act as income depositor. One of the creditors can act in the same capacity with the agreement of all the other creditors. The debtor cannot act as income depositor. (Article 44.) [2].

The person, managing the sale, obtains the information from Pledge Registry, in order to prepare the list of creditors, containing the priorities of their claim rights and sums of money, that are due to each of the creditors. After the creating the list, it has to be provided to the debtor and all the creditors who have the interest in the pledged property. According to the Article 33.2 of the Law on Registered Pledges it is assumed that the information contained in Pledge Registry is correct, however Article 45.4 allows the creditor and the debtor to contest the information contained in the list, by providing their objections in the next five days, including the day, when the manager of the sale had provided them the list.

The Law on Registered Pledge gives the manager of the sale the capacity to modify the list, based on the objections received, or to inform the creditor and the debtors, that the list is not going to be changed. Objections to that decision are resolved with the help of the court.

According to the Article 46 of the Law on Registered Pledges the proceeds of the sale are to be divided between the creditors in 30 days. However, there is no time limitation for creating and spreading the above-mentioned list of creditors. Overall, the process does require considerable time investments in the legal proceedings and can sometimes be cumbersome.

The proceeds of the sale are divided in the following way:

1. Compensation of the income depositor;
2. Costs of selling the pledge;
3. Pledge storage costs;
4. Claims of the creditors according to their respective priorities;
5. Unsecured claims related to the pledge that is claims, that exceed the agreed amount of the secured claim;
6. The rest of the proceeds, if there is any, is paid back to the debtor;

If, the proceeds of sale of the pledge are not enough, to repay the debts due to creditors in accordance to the loan agreement, they have the right to attempt to recover the missing amount by suing the debtor. The target of that lawsuit is the other property of the debtor, up to the limits of his potential liabilities.

Articles 43.7 and 47 of the Law on Registered Pledges state, that absent the evidence of conspiracy between the creditor and the buyer of the pledge, the sale is considered to be fair and the buyer can acquire the pledge, even if the debtor is trying to contest the sales price and the following payments to the creditors. However, the creditors are themselves responsible for obtaining the highest price for the sale and not delaying the sale unnecessarily (Article 43.3 of the Law on Registered Pledges).

The income of the sale has to be used to cover claims related to the pledge. With that the law understands the amount of the debt that both sides had agreed upon, when filing and application for registering a pledge (Article 10.3.1 of the Law on Registered Pledge). Claims related to the pledge, which are not covered by the proceeds of the sale, are considered to be unsecured claims (liabilities).

The Law on Registered Pledges provides two ways for a creditor to realize his rights to the pledge and sell it:

➤ ***Selling a Pledge on the Auction***

If the creditor is not granted the rights to sell the property without an auction neither in the contract, nor in accordance with the Article 38.2 of the Law as the newest (last) creditor, the sale of the pledged property is done in accordance with the Article 37 of the Law on Registered Pledges (further termed “The Law”) and the Articles 2073 of the Civil Law and related articles. Article 37 of the Law specifies different actions that need to be taken, including advertising the auction in the official Latvian newspaper “Latvian Courier” and at least in one other newspaper no later than a month before the day of the auction. The notification should specify:

- the names and locations of the creditor and the debtor (their respective legal addresses), their registration data, but for private entities – their name and surname,
- a short description of the property on sale and its location,
- a place, when one can acquire the conditions of the auction as well as the starting bid,
- the time and place of sale, as well as the auctioneer, if the sale is entrusted to the third person,
- other rules of the auction, which the creditor believes necessary to be specified.



### ➤ *Sale of the Pledge without an Auction*

According to the Article 38 of the Law the creditor and the debtor can agree in their pledge contract, that the creditor has the right to sell the pledge without an auction. However, these rights cannot be granted to only one creditor. If such a right is granted, upon establishing the pledge, it is considered that all the subsequent creditors have similar rights.

At least 30 days before the planned sale of the pledged property, the creditor has to notify the Pledge registry about one's intention to sell the pledge. Before notifying the Pledge Registry, the creditor has to send a copy of this notification to the debtor.

The Pledge Registry is responsible for sending copies of the notification to all the other creditors. The notification has to include the following information:

- the names, legal address and registration data of the creditor and the debtor (for private entities – name, last name, address and personal code, of in the absence of personal code – some data of the identity documents),
- description of the pledged property,
- date and reference number of the pledge registration,
- the claim, which the sale is meant to satisfy,
- the condition that grants the right to the creditor to use one's right to the pledge (for example, the loan agreement or the law).

According to the Article 42.4 of the law, the debtor can contest this sales notice and the sale itself in court.

## **1.3. The Macroeconomic Role of Registered Pledge System in Latvia**

### **1.3.1. The Role of the Registered Pledge System in the Economic Development**

In order to explain the role of registered pledge system in the economic development, it is important to distinguish two parts of the economy:

- The real sector. This group includes businesses that offer services or goods on the market. They usually act as debtors or providers of pledges<sup>1</sup>.

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<sup>1</sup> This research does not consider the case, when one business receives a loan from the other one, that is the transaction occurs without involvement of the financial sector. This type of loans is relatively rare.

- The financial sector. This group includes financial institutions that redistribute funds, by taking unemployed financial capital from the branches of the economy, where there is a surplus and placing them elsewhere, where there is a shortage of funds. These institutions act as creditors, accepting the pledge.

Such a division in sectors is grounded in the fact, that the development of registered pledge system is dependent on two participants of the crediting process – the creditors (the financial sector) and the debtors – the businesses (real sector). The decisions these economic agents take are dependent on a series of conditions that are discussed below.

The creditors (financial sector), are ready to provide loans and accept registered pledge for collateral, if there is:

1. *the necessary legal foundation;*
2. *a developed financial sector, including the banking industry;*
3. *a developed secondary market for moveable property;*
4. *controlled inflation.* Inflation is the most significant factor out of everything that influences the loan interest rate, because, if the level of the inflation in the country is increasing, banks will compensate for that by including inflation costs in the loan interest rate, which invariably means a dramatic increase in the latter. Under the conditions of economic crisis in the country, it is almost impossible for banks to predict the level of inflation. The level of loan risk becomes extremely high and banks have to compensate with a higher interest rate for the loan, as well as conservative estimation of the value of the pledged property. The loan interest rate is usually determined by adding the value the creditor deems necessary to the interbank loan interest rate;

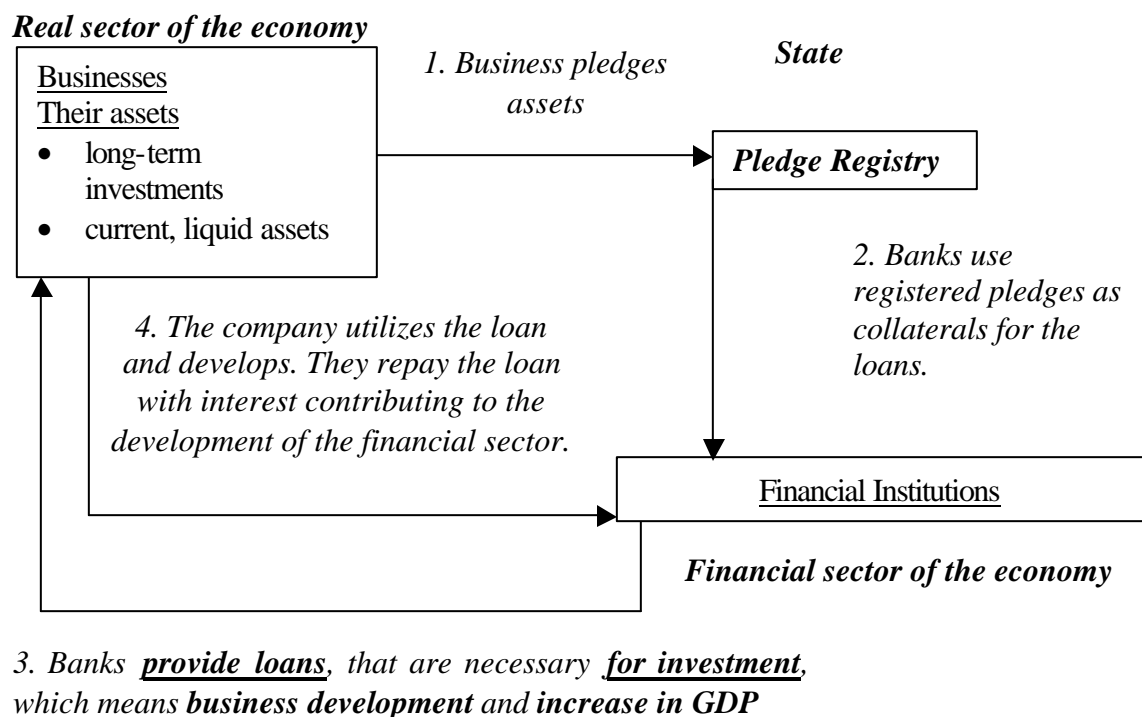
On the other hand, the borrowers, i.e. businesses who possess property, that can be pledged, are ready to offer their assets as collateral for the loan to further their development and pay the interest rate, when they deem the offer competitive and beneficial. Their decision making is also affected by multiple factors, such as:

1. *the amount of the loan,* that they will be able to get for their pledge,
2. in case of leasing – *the amount of down payment,,*
3. *the term of the loan,*
4. *the interest rate,*

5. *other* conditions related to obtaining the loan, the rules (insuring, evaluating the pledge, etc.) as well as payment schedules,
6. *speed of reviewing application for the loan and the amount of paperwork involved,*
7. *demands of the bank against the cash flow of the debtor.*

The macroeconomic role of the registered pledge system is shown on **Scheme 2** displaying the relationships between the main participants of the process.

**Scheme 2. The Impact of Registered Pledge System on Economic Development**



This scheme displays the process of providing loans and its main positive impact – further development of both the bank and the business, which ultimately results in the increase in the gross domestic product (GDP), which is one of the most important macroeconomic indicators.

The initiator of the process is the business, a part of the real sector of the economy, which possesses assets than can be classified as long-term assets and current, liquid assets. Almost anything of the assets of the business can be used as a pledge as long as it

is not prohibited by the law. Most of the assets are of the material nature, for example transportation vehicles, production machines, inventories of goods and materials, financial capital, etc.

*The main meaning of registered pledge in the cycle of providing loans to businesses is its usage as collateral for the loan.* Registered pledge is not the only possible type of collateral, however for businesses registered pledge is often the most appropriate type of collateral. Thus, *businesses can obtain additional financing in the form of loans using registered pledge for the collateral.* Financing is used to generate investment, the ultimate purpose of which is to increase the assets of the business – by expanding production, improving quality or, for example, by acquiring another company.

As businesses develop and increase their assets, they can be repeatedly used as collaterals for the loans. Apart from that, with the successful operation of the business, its profits, production or the quality of output increase, ultimately improving the economic situation in the country as a whole.

A similar process is occurring in the financial sector – by successfully placing their assets, banks positively influence the economy and create additional income for the state as well as themselves. In this way, loans positively influence the development of different businesses (on the microeconomic level) as well as the development of the economy as a whole (on the macroeconomic level).

*Therefore, the main macroeconomic role of registered pledge is to support the process of providing loans increases investment in the economy and therefore increases the gross domestic product.*

In the further chapters, we will consider the dynamics of these macroeconomic indicators in Latvia.

### **1.3.2. The Development of Loan Supply in Latvia**

The situation in the banking sector is universally believed to be one of the main indicators of the economic development. Indicators of Latvian commercial banks, which have been steadily growing during the last three years are an evidence of a period of stable development.

*Supply of loans* is a very important process in the economy, because it helps the businesses to achieve targets that are important for their development, such as the increase in current assets and continuing investment in the business. The last objective is especially important with Latvia joining the European Union.

In the last three years, the volume of provided loans has been rapidly growing, which can be explained by the relative economic stability in the country and an increase in the general wealth of the population. A decrease in the interest rates and loan risk was also undeniably conducive to the growth of the amount of loans. During these years, the Bank of Latvia has decreased the mandatory reserve rate, which is currently at the level of 3%. Therefore banks have the ability to divert more resources to providing loans. Currently, there is no evidence that this situation might change.

Successful development of loan supply in Latvia can be described with different indicators, such as:

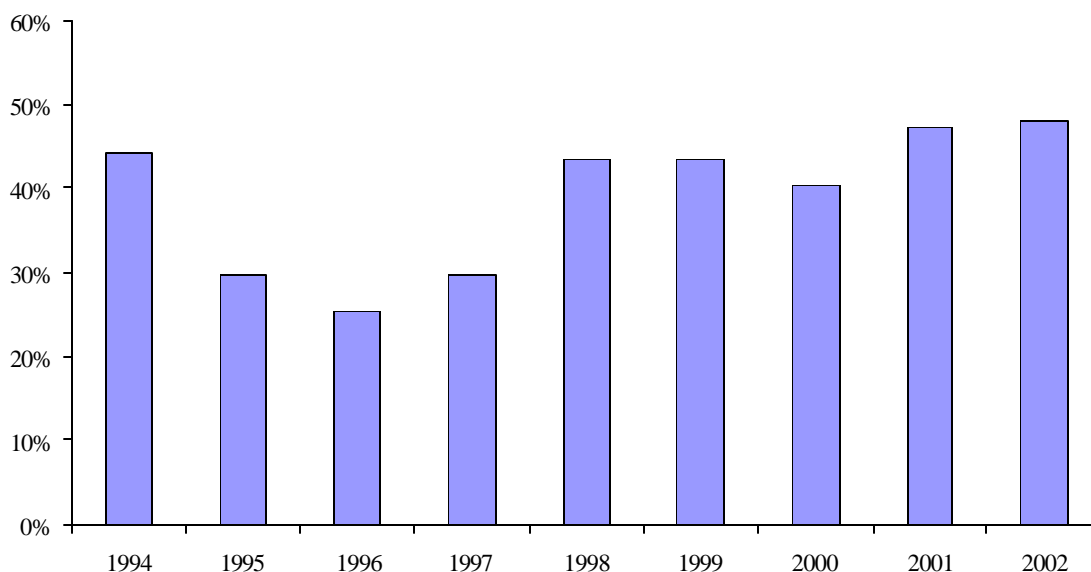
- the proportion of loans in the total assets of Latvian commercial banks (see **Table 1** and **Graph 1**),
- the total amount of loans provided by Latvian banks (see **Table 2**, **Graph 2**),
- the total number of registered pledges and the total amount of claims (see **Table 3** and **Graph 3**).

**Table 1**

**The Proportion of Loans in the Total Assets of Latvian Commercial Banks**  
(1994 – 2002) [5]

<b>Year</b>	<b>Loans as part of total assets, %</b>
1994	44,40%
1995	29,80%
1996	25,30%
1997	29,67%
1998	43,46%
1999	43,34%
2000	40,27%
2001	47,30%
2002	48,05%

**Graph 1. Loans in Total Assets of Latvian Banks  
(1994 - 2002, %)**



During the first years after the restoration of the independence (in the beginning of the nineties) many Latvian companies as well as persons had difficulties with obtaining bank loans. As specified above, this situation was not due to the abstract lack of banks willing to provide loans, but by a series of negative factors, such as, for example:

- overall unstable economic climate;
- the lack of adequate collaterals for loans, which significantly increased loan risk. It has been mentioned above that the notion and the system of registered pledge did not yet exist at the time;
- relatively high level of inflation and loan interest rates;
- the lack of trust in the banking system among the general population meant a limited volume of bank long-term resources [4].

However, in spite of all of the above-mentioned negative factors, the total amount of the loans in the bank asset portfolio in 1994 has already been 44.4% of the total assets (see **Table 1** and **Graph 1**).

Such a rapid increase in the loan portfolio, combined with the lack of experience or regulation in the banking industry became of the reasons for the crisis of 1995, which led to the decrease in loans from 44.4% to the 29.8% of the total bank assets.

After overcoming the consequences of the crisis in Latvian banking system, one could notice the positive tendency in the development of loan supply – Latvian banks began to actively provide loans, which meant further improvement of economic situation in the country, as well as by the fall in the interest rates for the 1-month Latvian bonds to 2.68% (1 month bond).

*One of the main results of these events is the development of adequate legal mechanisms for collateral and the creation of Pledge registry and corresponding legislation during 1998 – 1999.*

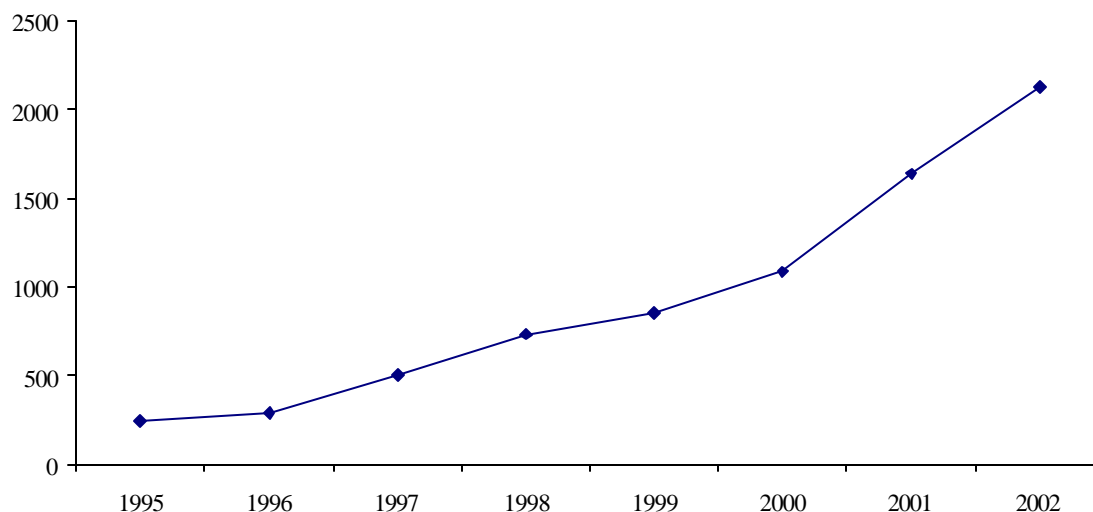
As it can be seen from the **Table 1** and **Graph 1**, in the end of the nineties loans had a clear tendency to grow in the total assets of Latvian commercial banks. Currently, the amount of loans in the assets has stabilized, remaining slightly under 50% (one should note, that in particular large banks it can achieve up to 75% of the total volume of assets), however since the absolute amount of bank assets is constantly growing, the absolute amount of loans is also constantly increasing, which shows the development and growth of Latvian banking system. This is shown on **Table 2** and on the **Graph 2**.

**Table 2**

**The Volume of Loans Provided by Latvian banks, mill. Lats (1995 – 2002) [5]**

<b>Year</b>	<b>Volume of Loans, mill. Ls</b>
1995	248,8
1996	287,7
1997	501,6
1998	732,6
1999	850,5
2000	1086,7
2001	1635,7
2002	2125,1

**Graph 2. The Volume of Loans Provided by Latvian Banks, mill. Ls  
(1995 - 2002)**



The balance of loans provided by the banking sector has exceeded 2 billion lats at the end of 2002 (with it being only 0.3 billion at the end of 1993).

The ratio of loans to GDP has also increased from the 18% in 1993 to 35% in the 2002. The fastest increase in loans was observed in 2001 (by 50.5%), with the significant development in the economy at the same time (GDP has increased by 7,6%).

A significant part of the loans provided were mortgages (in 2002. they were about 20% of total loans). However, the greatest weight in the bank loan portfolio belongs to the commercial loan – more than 40% in the 1<sup>st</sup> quarter of 2002 [5].

Obviously, with such a rapid growth in the loan portfolio, special attention has to be paid to the quality of the loans, because a large amount of bad loans can easily destroy the financial system of the country. This has been proved by the banking crisis of 1995.

In order to further encourage development of loan supply, at the same time improving the quality of loans provided, different measures were taken lowering the total loan risk. *One of the most significant innovations of that kind is the creation of the mechanism of registered pledge that secured creditors from fraudulent operations with collaterals. The development and enforcement of legislation has ensured relatively quick increase in the number of registered pledges and the total amount of claims* (see Table 3 and Graph 3).

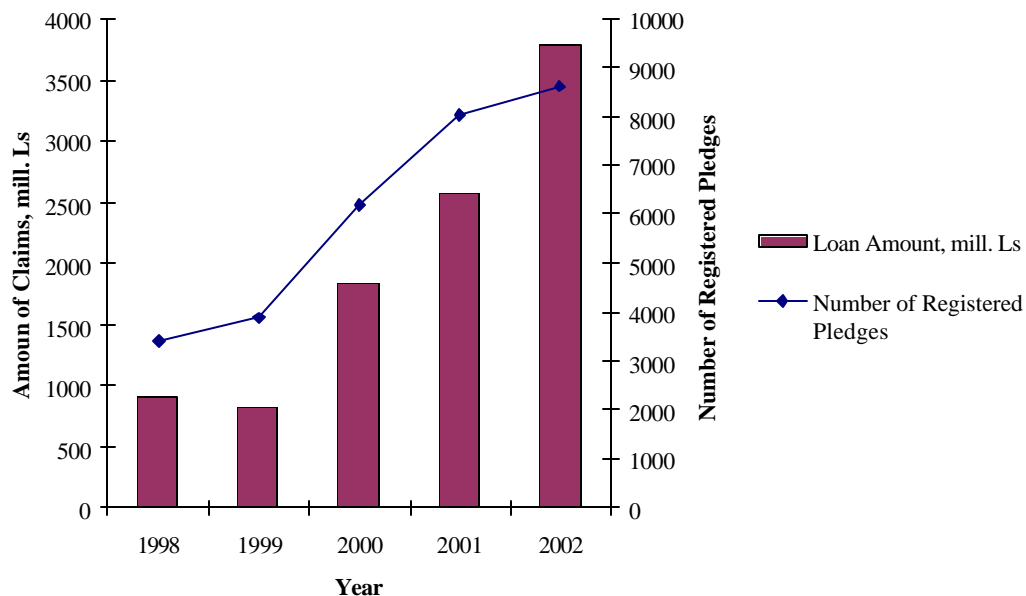


**Table 3**

**The Number of Registered Pledges and the Total Amount of Claims  
(1998 – 2002)<sup>2</sup>**

Year	Number of Registered Pledges	Total Amount of Claims, mill. Ls
1998	3381	915.740.353
1999	3876	827.260.641
2000	6206	1.839.608.938
2001	8014	2.571.891.774
2002	8610	3.791.471.949

**Graph 3. The Number of Registered Pledges and the Total Amount of Claims (1998. - 2002.)**



From the **Table 3** and **Graph 3** it is possible to see that registered pledge has the potential to become the most popular collateral for the loans, with its popularity rising dramatically.

Other measures, such as the accumulation and publication of information about the loan operations of different businesses in freely available or paid databases have also contributed to the decrease in credit risk.

It is important to note, that specific amounts of utilized loans, their types and dynamics in different industries are determined by the significance of corresponding

<sup>2</sup> According to the data in the Lursoft database.

industry in the economy, the particularities of its operation, as well as *the volume of investment*, its structure and financial condition of the industry.

### **1.3.3. The Dynamics of Investment in Latvia**

Among all the factors describing the overall economic climate in the country, development of the business activity is particularly important in context of this research. It is the entrepreneurs, who use the mechanism of registered pledge, in order to obtain finances (loans) to finance their operation and development (investment).

It is possible to point out the dynamics of investment (capital formation) as one of the macroeconomic indicators of business activity in the country. Quite naturally, here, just as in loans, there is a positive tendency to be observed.

The average growth rate of the investment in Latvia from 1996 till 2002 has reached 17.9%, almost four times exceeding the average GDP growth over the same period of time. Therefore, the investment part of the total GDP has increased from 18.3% in 1996 up to 26.4% in the 2002, which is the highest indicator among the European Union candidate countries.

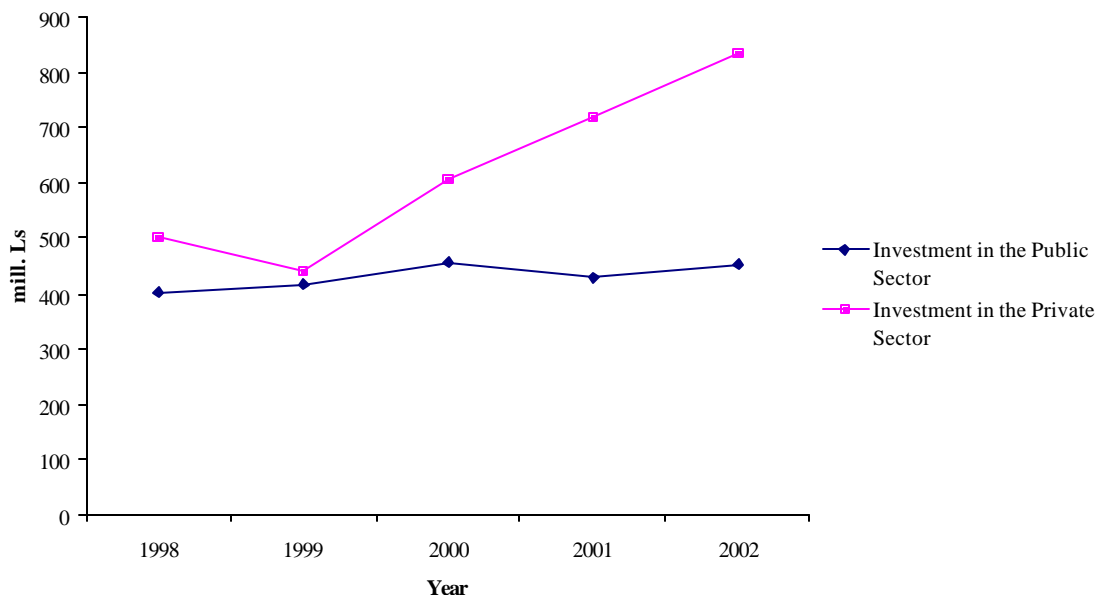
**Table 4** and **Graph 4** show the dynamics of investment (gross capital formation in real prices) [9].

**Table 4**

**Investment in the Public and Private Sectors in Latvia  
(1998 – 2002) [9]**

<b>Year</b>	<b>Investment in the public sector, m., Ls</b>	<b>Investment in the private sector, mill. Ls</b>
1998	400,8	502,7
1999	417,0	441,2
2000	455,6	607,3
2001	430,1	718,7
2002	453,6	837,4

**Graph 4. Investment in the Public and Private Sector in Latvia (1998 - 2002)**



When studying the dynamics of investment by forms of property, it is possible to see, that during the period from year 1998 to the 2002 the rapid rise of the investment was mainly caused by the investment in the private sector. Their average annual growth has achieved almost 33%, which is almost four times greater than the same indicator for public sector. This is also an important fact, because loans are one of (but, of course, not the only one) the most widespread private sector investment financing sources, different, from public sector, where tax money could serve as the source of financing.

It also has to be noted, that the volume of the investment in the public sector, during the time period under consideration has remained virtually unchanged, fluctuating about 450 million lats.

#### **1.3.4. The Dynamics of Gross Domestic Product in Latvia**

Ever since the middle of the nineties, there is a relatively stable tendency of economic development and growth of the gross domestic product (GDP) existing in Latvia.

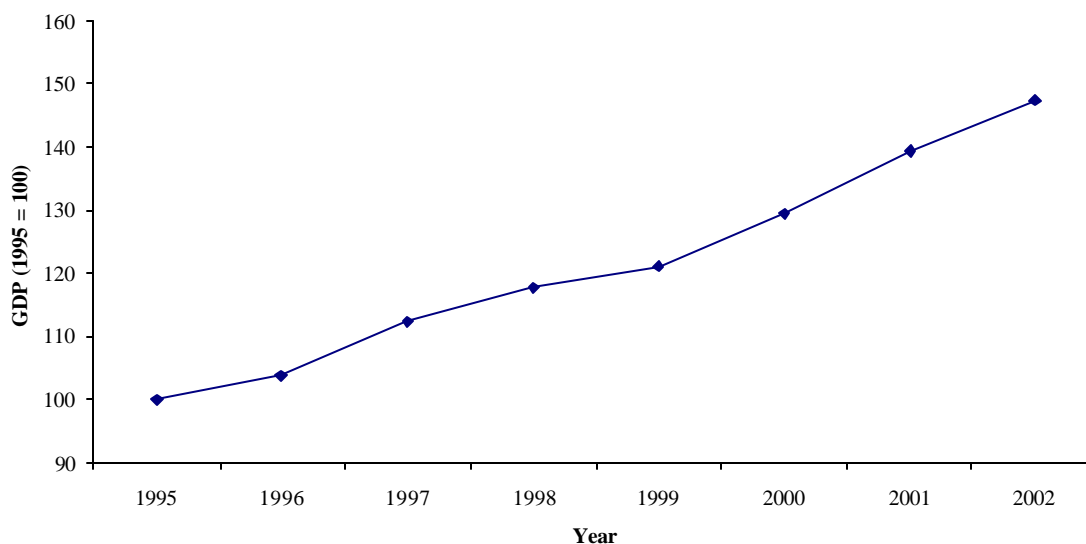
**Table 5** and **Graph 5** show the dynamics of Latvian GDP (indexed in real prices assuming the 1995 for the base year) [9].

Table 5

**Latvian GDP (indexed, assuming the GDP of 1995 equal to 100)  
(1995 – 2002) [9]**

Year	GDP
1995	100,0
1996	103,7
1997	112,4
1998	117,7
1999	121,1
2000	129,3
2001	139,6
2002	148,1

**Graph 5. Latvian GDP (indexed, assuming the 1995 GDP = 100)  
1995 - 2002.**



During the time period from 1996 to the year of 2002, Latvian GDP has grown by almost 50%. In particular rapid growth has been observed in 2001 and 2002 – 7.9% and 6.1% respectively. Currently, the rate of Latvian economic development is decreasing, mainly due to the weak external demand for exports and overall negative tendencies in the world economy.

Although the rate of GDP growth is much higher than in the developed Western countries (for example, the average rate of GDP growth in the countries of the European Union is only approximately 2%), in Latvia *the GDP per capita*, calculated in the

purchasing power parity units is still only 33% of the average level of the European Union, according the Eurostat data [9].

*Thus, after analyzing the abovementioned tendencies in Latvian economy, we can conclude, that the system of registered pledge – the legislation and state institutions forming the mechanism of registered pledge have direct influence on the economic conditions in Latvia. The development of registered pledge system exerts a positive influence on different spheres of Latvian business and economic processes. This positively influences the ability of companies to further their development, using bank loans, which leads to the increase in the income of the state, obtained through taxes, overall economic development, increase in GDP, the development of financial market and other positive phenomena.*

*Therefore it is increasingly important to analyze and improve the mechanism of the registered pledge, in order to stabilize what has been achieved already and ensure further development.*

## 2. The Impact of the Registered Pledge on the Loan Decisions in Latvian Commercial Banks

### 2.1. The Questionnaire of Latvian Commercial Banks on the Registered Pledge System

A questionnaire targeted at commercial banks was developed as a part of this research. The aim of the questions was to determine the influence of the registered pledge system on the process of providing loans in Latvian banks, by describing the influence

- *quantitatively*, by summarizing the relationship between the registered pledge and the following factors:
  - o loan interest rates,
  - o loan amounts,
  - o the popularity of different types of property as registered pledge.
- as well as *qualitatively*, summarizing the opinion of the banks on the following questions:
  - o the criteria of accepting a registered pledge;
  - o the problems of registered pledge system;
  - o recommendations of banks for state institutions and the Association of Commercial Banks of Latvia.

The actual questions contained in the questionnaire are provided in the **Appendix 1**. 6 out of 23 commercial banks operating in Latvia chose to respond to the questions. However, they represent all of the three groups in the banking sector<sup>3</sup>. The results of the questionnaire are summarized in **Tables 6 – 11**. The statistical information in those is accurate as of the March 31<sup>st</sup>, 2003, but since the nature of the information allows stating that the tendencies it describes are unlikely to change very rapidly and the data can be considered relevant for future time periods.

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<sup>3</sup> One can separate three groups in the Latvian banking sector, based on the volume of assets of the bank. The first group – large banks have asset portfolio that is greater than 150 million lats, the second group – medium banks with asset portfolio, which is larger than 50 million lats and finally the third group – small banks with asset portfolios up to 50 million lats. Historically, in Latvia the size of the asset portfolio of the bank also determines the niche of operations and the potential clientele of the bank.

In order to establish the meaning of the registered pledge in questions related to the conditions of the loan, the following questions were included in the questionnaire:

- by how much percent can the interest rate be decreased dependent on different types of collaterals provided;
- what is the possible amount of the loan (as a percentage of the value of the collateral);
- how much are there of different types of collaterals in the total collateral portfolio of the bank;
- what kinds of collaterals are used for different kinds of loans;
- what is the proportion of total accumulated bad debt expenditure that is related to the loans, where registered pledge has been used as a collateral, (in %).

The aim of the questionnaire was not only to determine the influence of the presence of registered pledge on bank decisions about the conditions of loans, but also to research the place of the registered pledge among other types of collateral, to determine the proportion of the registered pledges to the total amount in the collateral portfolios and to determine unsolved problems in the legislation on the registered pledges.

In the questions, which concerned collaterals, respondents were offered the following possible types of collaterals (apart from the obvious registered pledge):

- real estate;
- publicly traded stock;
- wage;
- other types of collaterals, for example, bank certificates of deposit, third party guarantees, etc.

Since the registered pledge is a wide category in terms of the amount of property that can be involved, registered pledge as a type of collateral was divided by the following main types of property:

- transport vehicles;
- production machinery;
- inventories;
- other moveable property;

Further in this part, we shall consider the responses of Latvian commercial banks to the questionnaire, which will allow us to make conclusions about the influence of the registered pledge on the process of providing loans.

## **2.2. The Significance of the Registered Pledge for Banks in Making Loan Decisions**

### **2.2.1. The place of registered pledge among other pertinent factors**

The review of the loan application and the decision on it has already become the standard procedure in all Latvian banks, because that is the only way banks can remain capable to quickly react to client demands and remain competitive.

This kind of effective standardization means, that banks have a developed mechanism, which takes into account not only the presence of registered pledge (or other type of collateral), but also other factors, that could influence the decision of the bank on providing the loan.

It is possible to outline the following characteristics of the potential debtor, which are likely to be significant in the decision making process of the bank:

- ***the business plan of the client.*** A business plan is an all-encompassing document, which includes both general perspectives for the business (the popularity and novelty of the idea, the number of possible competitors, etc.), as well as very detailed financial calculations (the predicted amount of income and expenditure, possible sources of repaying the loan, etc.). The existence of this plan is particularly important for new companies or companies that have not yet been created and need money to begin actual operation. Commercial banks often mention the lack of a good business plan as the main reason for denying loan application.
- ***the credit history of the client.*** Relatively recently, there was no information accumulated on the Latvian businessmen that are debtors, however now, several databases are available, which summarize the information about the companies that failed to meet their obligations and their management. The main application of this information is preventing the possibility of repeated fraud being committed. When reviewing applications of the small businesses, personal credit history of the owner might also be of an importance.



- *the industry of the client.* Often, it is believed that certain industries of the real sector of the economy are more promising than others, and therefore obtaining loans for representatives of one industry might be easier than for the representatives of the other. These conclusions might be based, for example, on the weight of a given industry in the GDP; however they are not really uncontested. Although retail trade comprises more than 20% of the Latvian GDP, not all banks would be ready to provide loans to yet another trading company, because the possible market for them is already very saturated.
- *the income flow of the client.* For the existing companies, this aspect might play the most important role, because it directly describes the chances of repaying the loan and the interest in the future.
- *the type of collateral offered* – real estate, registered pledge, bank deposits, etc.

Thus we have determined five main criteria (including the existence of the registered pledge), which banks could take into account, when reviewing an application for the loan and deciding on it. In order to determine, what place among the above-mentioned criteria does the presence of registered pledge take, a question was included that was asking the respondents to arrange five factors in the order of their importance for their decision-making. The replies of the respondents are summarized in **Table 6**.

**Table 6**

**Evaluating the Importance of Client Characteristics in the Decision-making of Latvian Banks<sup>4</sup>**

Criterion	The Importance of the Criterion (1 – most important, 5 – least important).				
	1	2	3	4	5
The business plan of the client	16,7% <sup>5</sup>	16,6%	66,7%	-	-
The credit history of the client	66,7%	-	-	33,3%	
The type of collateral offered (real estate, <b>registered pledge</b> , deposit, etc.)	16,7%	66,7%	-	-	16,6%
The industry of the client	16,7%	-	16,7%	33,3%	33,3%
The income flow of the client	66,7%	16,6%	16,7%	-	-

<sup>4</sup> Results are based on the summarized responses of the questionnaire. Some banks felt unable to differentiate and assigned a “1” for two or more criteria, which explains the arithmetical inconsistencies.

<sup>5</sup> 16,7% of the questioned respondents believe that the business plan of the client is one of the most important criteria when making decision on the loan.

Although several banks mentioned that, in practice, it is different to strictly arrange the criteria that the question mentions, from **Table 6** it is possible to see, that the majority of banks that is 66.7% out of the banks questioned believe that the type of collateral is one of the most important factors (taking the second place after the credit history of the client and ones income flows, whose significance banks rated the highest), in making the decision on providing the loan. This is a testimony to the fact, that registered pledge has become a type of collateral that can be used by both banks and companies that are looking for loans.

Still, it is possible to see from the **Table 6** that the collateral is not the main factor, indeed there were banks, which ranked that factor last. When taking decisions on providing loans, banks consider factors such as the revenue stream of the client and one's credit history to be of primary importance.

### **2.2.2. Evaluating a Pledge when Making a Decision on the Loan**

From the bank standpoint, every pledge has multiple risks associated with it, because the object of the pledge can be stolen or sold, and its value decreases during its usage. Therefore banks agree to provide only 65% to 80% of the actual value of the pledge as a loan (including the interest payments), which is to be secured with that pledge. The percentage, obviously, can fluctuate, depending on other risk factors, the bank decided to take into account.

Every potential pledge is classified by the bank from the criteria or its acceptability and sufficiency. The acceptability of the pledge is determined by two elements – the quality of the value and the ability of the creditor to control its safety.

In the ideal situation an acceptable pledge has to have the following characteristics:

- stable value, easily expressed in money terms;
- the possibility to control the pledge;
- the possibility to quickly sell the pledge;
- the value of the pledge, which is greater than or equal to the loan provided;
- legally guaranteed rights on the pledge for the bank.

Bank's procedure of pledge evaluation includes the following elements:

- determining the property rights of the debtor over the pledge, and the reliability and sufficiency of the documents, that are required to register a pledge of given type;
- checking, whether the subject of the pledge doesn't have any national or cultural value, whether it is not state property and whether it can serve as a pledge according to the existing legislation;
- visual check of the subject of the pledge, if it is real estate, transport vehicle or another physical object;
- obtaining a confirmation of the fact, that the subject of the pledge has not already been used as a collateral for another loan, from the debtor;
- determining the market and pledged value of the offered collateral;
- determining the possible amount of the loan.

The time of the “useful life” of the pledged property has to be commensurate to the term of the repayment of the loan, it also has to be insured by the insurance company bank deems acceptable.

The typical conditions of the loan contract grant the rights to regularly inspect the subject of the pledge to the bank and add a responsibility for the debtor to ensure these inspections are possible. Bank may also ask the debtor to increase the value of the pledged property, if the bank determines that its value has decreased or has doubts about the timely repayment of the loan.

Summarizing all of the above-mentioned, it's possible to state, that, when deciding the questions of the acceptability and sufficiency of the pledge, bank has to take into account the following factors:

- *the liquidity of the pledged assets, which is determined by the following:*
  - the existence of the secondary market;
  - a variety of potential buyers;
  - the existence of independent evaluations: for certain objects (for example, transport vehicles or machinery) it is required to obtain the evaluation of the independent inspector about their market and liquidation value;
  - the possibility of determining the market price;

- the cost associated with the potential disassembly, transportation, storage and sale.
- *the quality of the assets, which are included in the pledge.* This can be evaluated using financial reports and more detailed specifications;
- *the relationship between the market value of the pledge and the size of the loan, according to the credit policy of the bank,* and how often does it have to be reviewed. Bank in this case is concerned with the liquidation value of the pledge;
- *the immunity of the pledge against inflation;*
- *the ability to lawfully claim the pledge,* in case the debtor is defaulting on his contract commitments. Before providing the loan, bank has to check whether there are already claims in existence, that target the assets, which are offered as a pledge;
- *the availability to control the existence of the assets that are pledged* (prohibitions on transport vehicles, inventory financing schemes, etc.) and *the possibilities of repossessing them, in case of bankruptcy of the business.* Bank has to perform periodic checks of the existence and condition of the pledge. The object of the pledge is reviewed on site, as the representative of the bank evaluates its physical condition and appropriateness for the loan provided;

Therefore, *banks may not accept a pledged property for the collateral due to the following reason:*

- the value of the potential pledge and the amount of loan demanded does not correspond to the requirements of bank's credit policy;
- the evaluation of the pledge is considered invalid or inadequately high;
- it is not possible to provide sufficient control over the pledged assets for the whole term of the loan (for instance, debtors are registered in the foreign countries);
- different 'complications' (prohibitions, location in the closed or closely regulated territory, unclear property rights, etc.);
- lack of liquidity for a pledge (due to having inappropriate physical condition, for example, transport vehicle, which is older than 5 years, or a limited market, where

- it is possible to sell the pledge) or potentially larger problems with claiming the pledge (costs, legal obstacles, etc.)
- the financial data, which is used as a foundation for determining the value of the pledged property, is deemed doubtful.

In the next chapters, we shall review how banks value registered pledge, not only when making the decision about providing the loan, but also, when deciding on the conditions of the loan.

## **2.3. The Significance of the Registered Pledge in Determining the Conditions of Loan Provision**

### **2.3.1. Relationship between the Interest Rate and the Collateral Offered**

In the previous paragraph, it was concluded, that registered pledge has a significant influence on the decision of the bank about whether a particular project is worth to be financed by the loan. However, this is only the first decision, which the banks personnel have to take, implementing bank's loan policy. In case, if there has been a decision to provide a loan, it is necessary to respond to a series of follow-up questions, which determine the conditions of the loan. Among the main considerations are:

- the interest rate (as well as its relationship to the type of collateral offered);
- the amount of the loan (and its relationship with the declared value of the pledge),

In this chapter, we will review the opinions of the respondents on the relationship between the interest rate and the type of collateral offered. The answers of the respondents to the question that deals with this issue are summarized in **Table 7**.

**Table 7**

**Variability of Loan Interest Rates by the Type of Collateral in Latvian  
Banking System (31.03 2003)<sup>6</sup>**

<b>Type of Collateral</b>	<b>Possible decrease (increase) in the loan interest rate, % (from - to)</b>
Real estate	-0.5% .. -3%
Moveable property (registered pledge), including:	
• motor vehicles	-0% .. -2%
• inventories	-0% .. -1%
• machinery	-0% .. -2%
• other moveable property	-0% .. -1%
Publicly traded stock	-0% .. -1,5%
Salary	-0% .. +12%
Other types of collateral (including bank deposits, etc.)	-0% ... -4%

It is necessary to mention, that not all banks allowed the possibility of decreasing loan interest rates. Multiple banks have indicated that it would be dependent on the status of the client and the outcome of talks.

From **Table 7** it is possible to see that the largest decreases in the interest rate are possible if real estate is offered as collateral (with the exception of category of “other collaterals”, which includes such absolutely liquid collaterals, as, for example, the deposits in the bank). This is easily explainable by the rapidly rising prices of the real estate and well established secondary market.

Commercial banks are also quite lenient, if the proposed collateral for the loan is a type of registered pledge. Banks are ready to decrease the loan interest rate by up to 2%, depending on the type of the moveable property pledged. Banks give the lowest discounts on the interest rates for loans, which are secured with the less liquid pledges, for example, “other moveable property” usually includes items, which are quite specific and therefore less liquid.

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<sup>6</sup> Results are summarized based on the questionnaire.

### **2.3.2. The Possible Loan Amount Depending on the Type of the Collateral**

Replies of the respondents to the question dealing with the relationship of the possible loan amount and the type of collateral are summarized in **Table 8**. It has to be noted, that all of the respondents allowed significant differences in the possible loan amount in their answers – on average a difference of 20% with the same types of collateral.

**Table 8**

**Variability of Loan Amounts by the Type of Collateral in Latvian Banking System (31.03.2003)<sup>7</sup>**

Type of Collateral	Possible Loan Amount (from – to, % value of collateral)
Real estate	70% - 85%
<b>Moveable property (registered pledge), including:</b>	
• motor vehicles	50% - 90%
• inventories	50% - 60%
• production machinery	50% - 80%
• other moveable property	50% - 60%
Publicly traded stock	70% - 95%
Salary	40% - 300%
Other types of collateral (including bank deposits, etc.)	10% - 100%

From **Table 8** one can see that different categories of the registered pledge (transport vehicles and production machinery) overall allow obtaining the same amounts of financing as other types of collateral. The financing that it is possible to attract using inventories and machinery for a pledge is slightly lower. Similarly as with the interest rates, the cause of this is the specific nature of these collaterals – for instance the inventories of raw materials can be much harder to sell than the real estate.

### **2.3.3. Using Different Types of Collaterals for Different Types of Loans**

In order to determine what collaterals are used for different types of loans, the possible loan options have been divided by two different criteria:

- by term – short-term and long-term loans;

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<sup>7</sup> Results are summarized based on the questionnaire.

- by objectives
  - mortgage loan – for acquiring real estate;
  - industrial loan – to acquire production machinery or develop production;
  - commercial loan – to increase the amount of current assets;
  - overdraft – a small line of credit, secured by salary and used for different purposes;
  - consumer loan – intended for private entities for purchase of durable goods and other similar purposes;
  - financial leasing – rental with the rights to purchase;

Differently, from the questions, discussed above, in this question respondents were offered only two types of collaterals – registered pledge or any other collateral. Not all banks decided to respond to this question.

The answers of the respondents to the question about division of collaterals between the short-term and long-term, are summarized in **Table 9**.

**Table 9**

**The Composition of Collaterals in the Long-term and  
Short-term Loans in Latvian Banking System  
(31.03.2003)<sup>8</sup>**

	Type of Collateral			
	Registered Pledge		Other Collaterals	
	Long-term loans	Short-term loans	Long-term loans	Short-term loans
<b>The proportion of total collaterals, % (from - to)</b>	15%- 50%	0%- 70%	50%- 85%	30%- 100%

From **Table 9** it is possible to see, that registered pledge is currently more popular for short-term loans, although some banks refuse to consider it for securing short-term loan at all. For long-term loans, other types of collaterals are likely to be used, most likely real estate.

<sup>8</sup> Results are summarized based on the questionnaire.



**Table 10**

**Collaterals in the Secured Loans in  
Latvian banking system (31. 03. 2003.)<sup>9</sup>**

Type of Secured Loan	Total collateral s	Including	
		Registered Pledge, %	Other types of collaterals, %
Mortgage Loan	100%	0% - 13%	100%- 87%
Industrial Loan	100%	2% - 41%	98% - 59%
Commercial Loan	100%	30% - 60%	70% - 40%
Overdraft	100%	0% - 28%	100% - 72%
Consumer Credit	100%	0% -50%	100% -50%
Financial Leasing	100%	0% -99%	100%-1%
Other Types of Loans	0%-100%	0%- 34%	0% - 66%
Factoring	0%-100%	0% - 56%	0% - 44%

It is possible to see from the data of the **Table 10**, that registered pledge has significant weight in the total loan portfolio created by Latvian banks. The 0% in the lines “Other Loans” or “Factoring” means that not all of the banks (actually this is related to the smaller banks in terms of asset size) provide these services. They also don’t use registered pledges for services such as overdraft, consumer credit, financial leasing or mortgage. The results of the questionnaire also allow to state, that the larger is the asset volume of the bank, the more the bank uses registered pledge to secure all kinds of loans.

The data in **Table 10** gives the ability to evaluate the role of the registered pledge among other types of collaterals. One can see that its usage varies from 30% to 60% in the commercial loans and achieves 99% in the financial leasing.

#### **2.3.4. The Weight of Different Collaterals in Bank Collateral Portfolio**

The answers of the respondents to the questions about the weight of different collaterals in the overall bank collateral portfolio and the bad debt expense accumulated with loans secured with those types of collaterals are summarized in **Table 11**. Several

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<sup>9</sup> Results are summarized based on the questionnaire.

banks were unable to differentiate among the types of registered pledges (vehicles, inventories, etc.) in their portfolio and therefore only offered a summary answer.

**Table 11**

**Collaterals in the Bank Collateral Portfolio (31.03.2003)<sup>10</sup>**

Type of Collateral	Proportion of total collaterals, % (from – to)	How much bad debts expenditure has been accumulated for loans secured with this type of collateral relative to the total? % (from - to)
1	2	3
Real Estate	14% - 69%	6% - 58%
<b>Moveable property (registered pledge) total, including:</b>	16% - 66%	28% - 51%
• <b>Transport Vehicles</b>	3% - 13%	4% - no data
• <b>Inventories</b>	7% - 12%	14% - no data
• <b>Means of Production</b>	3% - 10%	10% - no data
• <b>Other moveable property</b>	3% - 60%	
Stocks quoted on the exchange	1% - 29%	1% - 3%
Salary	2% - 3%	3% - 4%
Other types of collateral (incl. deposits in the bank, etc.)	3% - 28%	5% - 43%

Commenting the information in **Table 11**, it is necessary to mention, that although within the *bounds of one bank* the totals of second and third columns would be equal to 100%, after summarizing the responses of *all banks*, it is no longer possible to achieve 100%, because we only indicate the limits of indicator fluctuation.

It is necessary to note, yet again, a large amount of differences in responses to the question, for example, the weight of the real estate in one portfolio is only 14%, whereas in the other one it reaches 69%.

The weight of registered pledges in bank collateral portfolios is fluctuating from 16% to 66%, which proves that moveable property has become the most popular type of collateral. After analyzing the subcategories of registered pledge, one can conclude that banks accept all types of registered pledge for collateral: transport vehicles (3% - 13%),

<sup>10</sup> Results are summarized based on the questionnaire.

inventories (7% - 12%), production machinery (3% - 10%) and other moveable property (3% - 60%).

The differences in weights are explainable by the differing loan policies of the banks and their niches on the loan market. Thus, for example, banks, which place more attention to financing mortgages will naturally have higher amount of real estate in their portfolio of collaterals. On the other hand, banks, that primarily provide loans of other nature, use more moveable property to create their collateral portfolio.

After analyzing the maximum amount of accumulated bad debt expenditure for loans, that were secured by the registered pledge, it is possible to conclude that these loans overall are not riskier or “worse” than the loans that were secured by real estate. One can see, that accumulations for loans, which were secured by the registered pledge can achieve up to 51% of total accumulations and the same accumulations for loans secured by real estate can be as high as 58% of the total.

On the other hand, when analyzing the lower fluctuation limits for these indicators, one can notice that loans secured by registered pledge have a higher minimum amount of accumulations (28%), than loans secured by real estate (6%), *which is an evidence of the fact that full security of the registered pledge system has not yet been achieved.*

*Taking into account the fact, that registered pledge mechanism is primarily used for providing loans to businesses and this process has high significance for the economy of the country (see Part 1.), it is possible to predict, that as the problems of the registered pledge get solved (see Part 3.), registered pledge will be used to secure loans even more than it is used currently.*

### 3. The Problems of Registered Pledge System and Possible Solutions

After summarizing the results of the above-mentioned questionnaire from Latvian banks, as well as reviewing the literature on registered pledges, it is possible to point out a series of problems, which prove that, there is a necessity for improving registered pledge legislation and clarifying certain implementation aspects of registered pledges.

In this research the problems that are related to *improving the legislation* are divided into two groups:

- problems related to registering the pledge;
- the problems of harmonizing registered pledges with other ways of pledging.

*Problems, which are related to organizational aspects* are discussed separately.

#### 3.1. The Problems of Pledge Legislation

##### 3.1.1. The Problems of Registering a Pledge

➤ *Listing the Property that is Subject to Registration in the Law on Registered Pledges*  
*The Law on Registered Pledges does not exhaustively list types of property, which are subject to registration (Article 1.1.3).*

Therefore the parties to the contract might encounter difficulties related to pledging the property that is subject to registration, because the Article 10.3 of the Law states, that, in case, all of the property belonging to the business is being pledged, everything that is subject to registration has to be shown on the application for registration separately. Otherwise the property that is subject to registration is not considered pledged. An exhaustive listing of types of property that are subject to registration is also important due the Article 34 of the Law, which makes the person obtaining the property in case of repossession, to check for the information regarding the pledge status. It *probably would be logical to exhaustively list the property that is subject to registration in the law, in order to avoid unnecessary conflicts between the parties to the contract, as to which property is considered pledged and which*

*isn't. Conflicts like that might cause distrust of registered pledge mechanism and additional workload for the courts. [4].*

➤ *Claiming the Right to a Pledge*

A problem of a similar nature is in the consequences of failing to register the pledge. According to the Law on Registered Pledges, if the parties have signed a contract about establishing a pledge, however it has not been registered in a due process, the creditor cannot claim one's right to the pledge and the contract is not binding to third parties, however, the pledge agreement itself is still in force. In this case the creditor can file a personal lawsuit against the debtor. The subject of the lawsuit is registration and none of the sides can default on its obligations only because of the fact, that the pledge is not registered. The right of the primary claim for such a pledge is established at the moment of registration.

It follows from this norm, that *even if the pledge is established, by providing its subject under control of the creditor, the latter cannot utilize ones rights without the registration.* If a direct pledge contract would be signed, this problem would not exist for the creditor. Therefore this provision of the law essentially puts the creditor in the worse position, that if a direct pledge treaty would be signed. This, of course, flies in the face of the idea of the Law in Registered Pledges, which is to give the creditor additional guarantees rather than taking away some right. Due to these reasons, a correction of the law would be necessary [4].

The rights of creditors are also limited by the fact that:

- *Other parties can claim property that is the subject of the registered pledge;*
- *Other parties can ultimately seize property that is subject to registered pledge. Thus for example, it is possible to claim stockholder's equity that is pledged and registered in the Pledge Registry. Enterprise Registry (as well as Commercial Registry) has access to Pledge Registry, therefore this should not be possible.*

*Therefore, in order to provide the creditor with additional guarantees:*

- *One should equalize the rights of the creditor in case or registered and direct pledge contracts;*
- *One has to specify the possibilities of claiming the subject of registered pledge;*

- ***One has to specify the possibilities of claiming the subject of registered pledge for other parties.***

➤ Possible Obstacles to Registration

Another important problem, which is related to the registration of the pledge is ***an inadequate definition of the obstacles to registration.*** The Law on Registered Pledge states that it is not possible to register the pledge, if one discovers legal obstacles to establishing a registration. In the Law these obstacles are defined as follows:

- the debtor is declared insolvent, except when the pledge is made by the administrator;
- pledge registry contains a record forbidding repeated pledging of property;
- not all of the required documents are submitted or they do not correspond to the requirements of the law.

However, the law on Registered Pledges does not mention the information obtained in other registries as the possible legal obstacle to registration. This could be important, for example, if the parts of stockholders' equity are being pledged and the database of the Enterprise registry has no record about the parts belonging to the debtor or the information about the debtor does not correspond to the information in the Population Registry. According to current Law on Registered Pledges, checks that would discover the above-mentioned fraud attempts, do not have to be performed, even though it would increase the safety of the system overall.

Taking into account, that this does not require much legislative or any other kind of work, ***it would be logical to clearly specify that the Pledge Registry when deciding on the outcome of the registration has to check against the data in other public registries.*** Technically it is possible and is actually usually done. In addition it would help to update the databases of other public registries with the effects of the newly occurring transaction. Of course, when solving this problem, we have to calculate the necessary expenditure, for example, software updates or information exchange as well as to determine the ways to the source of financing. This could be where the state fee for pledge manipulation could be applied, which might also require to changes in the legislation on those registries [4].

➤ Clarifying Priorities of the Pledges

Yet another potentially problematic fact is that, the Law determines that when registering a pledge, the Enterprise register enters the pledge registration number, registration date and creditor priority, if some property is being pledged repeatedly. ***The law does not provide an answer, on how to register a pledge in case if several things are registered as a part of one pledge, a part of them for the first time and other repeatedly, without previously specifying a prohibition on repeated pledging.*** It is necessary to clarify this question, in order to make the system more secure against fraudulent attempts to pledge property multiple times. [4].

➤ Other Problems of Registration

- Article 48 part 2.3 of the Law states: the right to claim a pledge is over, if: “...five years have passed since registering a pledge and there is no written notice from the creditor on prolonging the claim, specifying the extended term. Banks, who are the typical creditors believe, that ***this term has to be extended without any requirement of notices.***
- The law also does not specify, that when applying for changing the terms or renewing a pledge, Pledge Registry has to receive the original registration documents to cancel them. As a result both parties to the contract are left with invalid documentation. This can potentially be abused.
- The law should also specify that only ***the creditor can recall the already submitted application for registering a pledge.***
- One should clarify, ***whether the renewed pledge should be registered as a new agreement or as a change in the terms of the original registration agreement.***
- ***The questions on pledge priorities have to be resolved, because*** in practice there are often cases, when pledge priorities are assigned by the number of creditors and not by the number of claims.
- Finally the ***law does not provide that in case the property is unjustifiably claimed by another party,*** the original claim of the creditor should be transferred to any proceeds from that transaction. This limits the rights of the creditor and decreases the responsibility of the debtor. [4].

### **3.1.2. The Problems of Harmonizing Registered Pledge with Other Types of Pledges**

#### **➤ Relationship Between Registered and Other Types of Pledges**

Another important realm of problems is the relationship of the registered pledge to other types of pledges. For example, ***different types of pledges with different legislative basis in different laws can be established on the same transport vehicle***: the pledge can be established by the Law on Road Traffic, as well as by the Law on Registered Pledges. In addition the laws don't clearly specify the priority of one method over another. Currently, the Enterprise Registry has prepared changes in the legislation to exclude the ability to register a pledge outside the Enterprise Registry framework. [4].

#### **➤ Priority of the Registered Pledge Over the Other Ones**

The Law on Registered Pledge states that registered pledge has the priority over the unregistered one. ***The Law does not clearly specify that registered pledge has a priority over any pledge, which is not registered in a due process***. This could be important, for example, in the following, currently hypothetical case: if any moveable property registry, acting on request of the owner of the property had included in its database the information on that property being pledged and made a corresponding remark on the contract itself. Such a possibility is not clearly defined in the law, but is also not prohibited. Such a pledge, however, cannot be considered to be registered the way the Law on Registered Pledges understands it, because this registration is not founded in that, however the law should probably be clarified. [4].

***Both of the problems above could be solved by preventing other registries to register pledges, which have not previously been registered in the Pledge Registry.***

#### **➤ Registration of Pledged Transport Vehicle in RTSD (Road Traffic Safety Directorate)**

In cases, when the subject of the pledge is a transport vehicle, which is registered in RTSD, the personnel of RTSD do not have a ***unified opinion on the following questions***:

1. If the registration of a transport vehicle is changed to the new owner (if the creditor has used the right to sell the subject of the pledge for a free price without mediation of the court and organizing the auction). Who should sign the act of change of



ownership – the creditor and the new owner or the debtor and a new owner with the acceptance of the creditor?

2. If the existing pledged transport vehicle registration is erased from the RTSD database, should the note of the pledge remain until re-registering the vehicle to a new owner or should it be erased with the deletion of the existing registration?
3. Whether the debtor can register pledged transport vehicle (not previously registered in RTSD) for another person, without an agreement from the creditor?
4. RTSD database has to be more organized, because there are often problems with prohibitions to pledge, which have been erased in a due process, but persist in the database.
5. One has to decide if traffic violations of a driver should be classified as obstacles to the pledging of a car.

### **3.2. Organizational Problems**

#### ➤ *In the operation of pledge registry:*

- more precise information is required about the number of documents and what they should contain to register a pledge;
- it is impossible to submit applications in the electronic form. A new system of electronic documents is necessary;
- it is impossible to register a pledge quicker than 5 days even for an additional payment.

#### ➤ *In Supervision and Monitoring of Pledges:*

- Goods, that are accepted as pledges, are easily moveable and something like their fraudulent sell-off is basically impossible to control;
- Debtor can fraudulently change the newest pledge subject to the physically older one, as long as the subject of the pledge is impossible to identify by serial numbers or other marks

#### ➤ *In Organizing the Auction:*

In case of insolvency auctions are organized by the administrator or their rules are agreed with the administrator. The administrator can also freely manage the funds obtained from the auction.

➤ *In Fulfilling Obligations of a Business (providing a pledge):*

- Businesses don't always present the necessary documents to the Bank in a timely manner;
- Businesses don't provide the ability for Banks representatives to check property on-site;
- It is sometimes difficult to get an insurance extension from the debtor;
- Pledged property can be overvalued (when valuator provides an evaluation according to the wishes of the client);
- A business is most likely to experience problems fulfilling obligations to the bank, if it actually becomes insolvent. Therefore almost all the advantages of creditor, holding a pledge, are lost as soon as the bankruptcy is filed – that is the bank loses the ability to control and quickly sell off the pledge. In case the business is in bankruptcy, the action of the bank, even as a secured creditor is limited and dependent on the goodwill of the administrator. We propose to implement changes in the Law on Bankruptcy, which would correct the above-mentioned drawbacks.

## Summary

After analyzing the tendencies in Latvian economy, we can conclude that registered pledge system exerts a direct influence in Latvian economic situation. As shown in the research (see Parts 1. and 2.), the development of registered pledge positively influences different spheres of enterprise and different economic processes:

- the ability of the businessmen to develop their companies using bank loans,
- development of financial market and banking sector,
- an increase in the tax income of the country,
- economic development and increase in GDP,

Therefore, it is very important to analyze and improve the mechanism of registered pledge in order to stabilize the already achieved successes and further development.

The analysis of the results of the questionnaire on registered pledge system and its impact for Latvian commercial banks (see **Tables 6 through 11**) allow to conclude, that ka even though registered pledge is a popular type of collateral for loans, *the safety of registered pledge system is not yet fully achieved.*

*Taking into account the fact, that registered pledge mechanism is primarily used for providing loans to businesses and this process has high significance for the economy of the country (see Part 1.), it is possible to predict, that as the problems of the registered pledge get solved (see Part 3.), registered pledge will be used to secure loans even more than it is used currently.*

After summarizing the results of the above-mentioned questionnaire from Latvian banks, as well as reviewing the literature on registered pledges, it is possible to point out a series of problems, which prove that, there is a necessity for:

- improving registered pledge legislation
- clarifying certain implementation aspects of registered pledges.

## Suggestions

1. In order for contract participants to avoid difficulties in deciding what is subject to registration and what isn't as well as unnecessary conflicts related to pledging the property that is subject to registration, which may cause decreased trust in

- registered pledge and additional work for the courts, *it would be logical to clearly specify everything subject to registration in the law;*
2. To provide additional guarantees to the creditor:
    - *One should equalize the rights of the creditor in case of registered and direct pledge contracts;*
    - *One has to specify the possibilities of claiming the subject of registered pledge;*
    - *One has to specify the possibilities of claiming the subject of registered pledge for other parties.*
  3. To complement the list of legal obstacles to registration of the pledge *it would be logical to clearly specify, that Pledge Registry has to check the data in other public registries when deciding on the registration of the pledge.*
  4. To avoid unjustifiably limiting the rights of the creditor:
    - *The term for registered pledge has to be extended in the Article 48, Part 2.3 of the Pledge Law;*
    - *The law has to specify, that when applying to renew or change the pledge, Pledge Registry has to be provided with the original pledge registration document to cancel it;*
    - *The law has to provide that the application for registering a pledge can be recalled only by the creditor;*
    - *One has to evaluate the question of pledge priorities, because in practice there are often cases, when priorities are assigned by the number of creditors, rather than by the number of demands;*
    - *The law has to provide that in case of unjustified repossession of the pledge the claim to the pledge should transfer to the reward obtained by the other creditor.*
  5. In order to harmonize the links between registered pledge and other ways or pledging one should *exclude the possibility to register collateral in other registries, which would not be a registered pledge.*
  6. Organizational problems have to be solved, by contacting appropriate institutions: Road Traffic Safety Directorate, Pledge Registry, and businesses.

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## **Appendix 1<sup>11</sup>**

### **The Questionnaire of the Association of Commercial Banks of Latvia research project „Registered Pledge System in Latvia”**

#### **The Aim of the Research:**

To study the system of registered pledges in Latvia, identify its drawbacks and develop recommendations, which would permit banks to be more successful in utilizing pledges in their operation.

Association of Commercial Banks of Latvia is asking the bank specialists to respond to the questions below until **June 9<sup>th</sup>, 2003**, the next meeting of the auditor committee.

Please send the questionnaire with your responses electronically to the following addresses: [zanete@banakasoc.lv](mailto:zanete@banakasoc.lv), or [lilija@bankasoc.lv](mailto:lilija@bankasoc.lv)

Taking into account, the practical meaning of this research for the banks and the expressed interest, the summarized results will be discussed in the Association of Commercial Banks of Latvia, by inviting appropriate specialists – auditors, loan specialists, lawyers, etc. The date of the event will be announced by e-mail.

Summarized results of the research will be available to all commercial banks in Latvia.

Questions are approved by Evija Sloka, Chairman of the ACBL auditor committee.

The research is organized by the Chair of the ACBL study and consultation center, Liliya Babre.

The research is managed, theoretical and practical part developed by Svetlana Saksonova, Ph. D. Economics, lecturer at the University of Latvia, Institute of Finance and ACBL Study Center

#### **Directions for the questionnaire:**

- Statistical information in the tables should be provided on March 31st, 2003.
- Use whole percentages for tables or round with the precision of 5%.
- If it's impossible to provide any data, please comment it in the remarks on the appropriate tables.

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<sup>11</sup> Please note, that the questionnaire was originally developed in Latvian only.

1. Please arrange the criteria offered in the Table by their importance in the decision of providing a loan (1 – the most important, 5 – the least important)!

Criterion	1	2	3	4	5
The business plan of the client					
The credit history of the client					
The type of collateral offered (real estate, <b>registered pledge</b> , deposit, etc.)					
The industry of the client					
The income flow of the client					

**Remarks:**

2. Please evaluate the influence of the types of collateral on making the following decisions (empty table columns) (assuming, that loan terms, amounts, revenue streams and other important factors are equal)!

Type of Collateral	By how much percent can the standard interest rate be lowered with this type of collateral?	What is the maximum possible amount of loan (% of the value of the collateral)?
Real estate		
Moveable property (registered pledge), including:		
• motor vehicles		
• inventories		
• machinery		
• other moveable property		
Publicly traded stock		
Salary		
Other types of collateral (including bank deposits, etc.)		

**Remarks:**

3. Please evaluate the following types of collateral by the criteria specified in Table columns.

Type of Collateral	Proportion of total collaterals, % (from – to)	How much bad debts expenditure has been accumulated for loans secured with this type of collateral relative to the total? % (from - to)
Real estate		
Moveable property (registered pledge), including:		
• motor vehicles		
• inventories		
• machinery		
• other moveable property		
Publicly traded stock		
Salary		
Other types of collateral (including bank deposits, etc.)		
<b>Total:</b>	<b>100%</b>	<b>100%</b>

**Remarks:**



4. Please fill in the table below, approximating which collaterals are used for what kinds of loans (by terms and groups)!

Type of Secured Loan	Total collaterals	Including	
		Registered Pledge, %	Other types of collaterals, %
Mortgage Loan	100%		
Industrial Loan	100%		
Commercial Loan	100%		
Overdraft	100%		
Consumer Credit	100%		
Financial Leasing	100%		
Other Types of Loans	0%-100%		
Factoring	0%-100%		

**Remarks:**

5. Please name the criteria that are used to evaluate the suitability of the registered pledge for providing a loan and determining the loan amount.

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6. Name the reasons for not accepting the pledge as collateral.

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**7. Name the problems in the Latvian registered pledge system and its interaction with banks, that are, in your opinion, unsolved.**

**In Legislation:**

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**In the operation of Pledge Registry:**

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**In controlling and managing registered pledges:**

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**In the operation of the court system:**

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**In organizing the auction:**

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**In obligations of a company, pledge provider**

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**In other aspects:**

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**8. Do you have any suggestions of what and how can be improved in the registered pledge system?**

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**9. What kind of help (educational or other) could institutions such as ACBL, FCMC and others (which?) provide to the commercial banks, so that the system of registered pledges would develop and operate even better?**

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